

MR. PREEG: I thank you, Mr. Chairman. I'm delighted to be here, and let me try to use my five minutes to give four principle reasons why I worry about the large and chronic trade deficit.

First, is the protectionist backlash, straightforward. Protectionist interests use the deficit as an argument to oppose liberal trade and to promote protectionist actions that can have adverse impact on our economy. It's a spurious argument, certainly with respect to recent trade agreements -- Uruguay Round, NAFTA. These have not been significant causes for the trade deficit, but, nevertheless, the arguments do resonate with public opinion.

And most worrisome is the fact that this has even been true in the last couple of years when we've had full employment and high growth. And, of course, if our economy does slow down, it will get worse.

The second worry I have is the growing costs of servicing the foreign debt as these current account deficits accumulate now we're into our 19th consecutive year. The U.S. has changed from a net creditor country of \$350 billion in 1980 to \$1.5 trillion net debtor last year, projected to \$3 trillion early the next decade at current rates. Servicing this

\$3 trillion projected increase in our indebtedness, costs in the order of \$200 billion a year, or two percent of GDP.

The key consideration in this, which I would hope the Commission could focus on, is whether the additional borrowing each year that has to match the current account deficit -- \$300 billion plus this year.

Whether that leads to incremental, productive investment in the U.S. or incremental, immediate consumption. It's a complicated macroeconomic issue.

My conclusion is that it's primarily consumption, possibly in the order of 80 percent consumption, 20 percent investment. And that meets debt servicing well into the future by our children for our current consumption binge.

My third worry is that much of the current account debt buildup of the 1990's has not been market-driven but has been based on political decisions by other governments to build up their dollar reserve holdings, which have roughly doubled to about \$1 trillion today.

These dollar holdings have had impact on the deficit itself, as explained in one of the attachments to my statement today, but the concern I have here is that this also gives foreign governments

potential leverage against the U.S. for commercial or for foreign policy objectives. They can threaten or actually move to switch out of dollars into euros or sell dollars.

It's not an immediate threat, because others want the strong dollar to stay that way now, but one can project ahead to a weaker U.S. economy, a much stronger Asian economy and China and Japan have the largest holdings. Therefore, I consider this a concern, a worry about the structure of how the deficit has worked its way into foreign official holdings of dollars.

And, finally, the fourth and most immediate, most important worry, is that the record deficit on current account projected years ahead, together with the cumulative debt service we now have, can have an effect on market volatility against the dollar as we approach the time where we need to adjust.

I think -- well, I certainly feel that it is inevitable, there has to be an adjustment -- but the issue is, is it going to be a soft or hard landing.

Having this deficit accumulated debt can be particularly unsettling to financial markets when this adjustment starts and could cause a more disruptive, harder landing as a result.

I'll just give one example. I received this report last week -- Lombard Street Research, Economic Review of May 1999. I don't know if you are familiar with it, but it's read in financial circles, and the director, Tim Congdon is now projecting that U.S. foreign debt, as a percent of GDP, currently about 20 percent, will go to 50 percent by 2008. That's only eight or nine years away. That's getting really up into LDC territory, and this could be unsettling to the financial people who read this sort of thing and say, "Hey, is the dollar really going to come down, and should we begin to get into other than dollar denominated financial assets?"

So, those are the four principle reasons.

Just two concluding comments -- the four reasons are basically independent in terms of how they impact adversely -- or could -- on the U.S. economy. But they could also have a cumulative impact, particularly when the adjustment begins whereby the dollar moves down and interest rates go up -- that can then trigger some of these other concerns I have listed and become mutually reinforcing.

And my final second and concluding point, my overreaching worry, if you will, is the fact that the U.S. Government, up and to this point at least, just

fails either to understand or certainly to admit that there's a real problem or that something needs to be done about it. It's the strong dollar uber alles, and the deficit is not something that needs to be dealt with urgently.

Meanwhile, other governments are very happy to keep their trade surpluses, which are the mirror of our deficit, and with each year of 300 plus billion dollar current account deficits and an ever-increasing net debtor position, I believe that the probability of a harder landing when the adjustment does take place will confront us.

Thank you, Mr. Chairman.

CHAIRMAN WEIDENBAUM: Thank you, Dr. Preeg,
and your cooperation in staying within the five minutes.

Our second briefer is Professor Susan
Collins of Georgetown University who's also a Senior
Fellow at the Brookings Institution.

Dr. Collins.